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Savills World Research
UK Commercial

Spotlight
Regional Office Market Review & Outlook

September 2016

Atria, Edinburgh (186,000 sq ft) - Purchased during Q1 2016 for £105m by Deka Immobilien, who were advised by Savills

- We expect regional take-up for the end year to reach 10.5m sq ft, 3% down on the level recorded in 2015, but 15% up on the long term average.

- Although the current uncertainty will inevitably affect business decisions going forward, we believe there are certain sectors including accounting and professional, which are likely to grow.

- We expect to see rental growth in all but one of the key regional cities in 2016, with the biggest year-on-year rental growth in Cardiff and Birmingham in 2016 with 9% & 8% respectively.

- We do not expect vacancy rates to rise significantly, as the heightened risk-aversion amongst developers, funders and lenders will lead to a reduction in development and refurbishment commencements in 2018 and beyond.

- Proportionally, more is being invested in office markets outside London. The market outside London accounted for a 30% share as at the end of July 2016 (long-term average is 23%) as investors seek higher yields outside the capital.

"A general shortage of new, Grade A office development in the UK regions will provide a solid basis from which the UK can recover post Brexit." - Jon Gardiner, Head of National Office Agency

■ All major cities in the UK have entered a period of considerable uncertainty as the effects of the EU referendum unwinds within the UK office markets. With the outcome of the referendum now firmly sinking in, what does the result hold for the future of the UK's office markets?

■ Arguably it is too early to draw any conclusions as to the impact of 'Brexit' but activity over the last few weeks is encouraging. Unlike the London market, where annual recorded take-up has oscillated significantly over the past five years, annual take-up in the regional office markets have been relatively stable and much more reliant on the local economy, and we expect this to put these cities in a good position going forward.

■ The UK regions have seen office based employment growth of 8.7% over the past five years, growing by 505,000 to 6.3 million. This has been driven by the administrative sector which has grown 18.6%, outperforming the London average of 14%.

■ Key regional cities, such as Leeds and Birmingham, with improved amenity offering, transport links and quality of buildings on offer, have continued to outperform the UK average employment growth over the last five years and we expect this to continue as we go into 2017.

Regional investment market

■ Despite pre-referendum concerns, the M25 and regional office investment volumes remained strong as at the end of July 2016 reaching £3.7bn, 37% above the long term average for this period. Bristol, Edinburgh and Manchester have all seen higher investment levels in 2016 than the same period in 2015.

■ Proportionally, more is being invested in office markets outside London. 30% was invested as at the end of July 2016 (long-term average is 23%) as investors seek higher yields outside the capital.

■ Overseas investors were the key contributors to this increase, accounting for £2.2bn of regional office investment as at the end of July, compared to £1.1bn over the long term average for this period, as appetite remained strong on the lead up to the UK referendum.

■ This is the highest proportion of overseas investment ever recorded in the UK regions, and we believe this trend could continue with overseas investors looking to take advantage of a weaker sterling.

■ For example, Savills advised German Real Estate Investment Company Deka Immobilien on the purchase of Atria, Edinburgh, from the City of Edinburgh Council for £105m, representing a yield of 5.35%.

■ There were also 13 deals over £50 million as at end July 2016, compared to the long term average of 8 deals. Investors have not been afraid to spend larger volumes on larger lot sizes in the lead up to the UK referendum.

■ In terms of size, the current headline deal for 2016 is the forward funding of Birmingham's Three Snowhill scheme for £200m by M&G Real Estate, the final piece of the jigsaw of the 1m sq ft Snowhill development, which is being speculatively built and will provide over 400,000 sq ft of space when it completes in 2018.

■ Another significant deal was 3&4 Piccadilly Place, Manchester in the first quarter for £115m which was acquired by Ares Management as the North West again saw the highest investment volumes of all regional cities.

■ Post Brexit, encouragingly, there is evidence of significant deals still being done. Deka Immobilien has acquired One St Peter's Square in Manchester for £164m via the owning joint venture vehicle from Argent and the Greater Manchester Property Venture Fund.

■ Investors have also started to take advantage of asset management opportunities going forward, which is likely to bring more stock to the market.

■ Following the outcome of the UK referendum, UK regional prime yields and M25 prime yields currently reside at 5-5.25%.

Regional occupational market

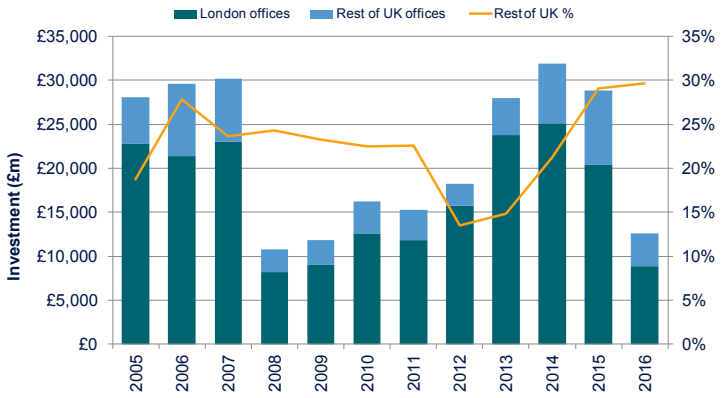
■ Structurally, the UK regional cities are in a strong position as we go through the second half of 2016. Take-up within the UK regional cities saw another strong first half reaching 4.4m sq ft, only 6% down on the record first half of 4.7m sq ft during 2015 and 11% above the first half average of 4m sq ft.

■ Despite overall take-up being lower in the first half of 2016 than over the same period in 2015, Grade A take-up was 3.4% higher, rising to 1.2m sq ft as occupiers searched for higher quality floorspace.

■ The most active business sector in the UK regions was the Insurance and Finance sector, closely followed by

GRAPH 1

Regional offices investment levels make up 30% of the UK total



Graph source: Savills/Property Data

One St Peter's Square, Manchester (288,000 sq ft) purchased by Deka Immobilien

the TMT sector, accounting for 16% and 15% of take-up, respectively.

■ Birmingham's Insurance and Financial take-up was particuarly strong, driven by the 90,000 sq ft letting of 1 Chamberlain Square to PwC. The sector accounted for 29% of take-up in Birmingham during the first half of 2016, above the five year average of 7%.

■ TMT has been a key business sector for a number of the UK regions over recent years, as rising rents in London has driven relocations to cities outside London, particularly in Bristol, Cambridge, Manchester and Leeds. For example, TMT take-up accounted for 32% of Bristol's take-up in the first half of 2016, significantly above the five year first half average of 21%.

■ In terms of take-up, Birmingham saw the strongest city centre take-up during the first half of 2016, reaching 450,000 sq ft, 27% above the five year average for this point in the year.

■ Glasgow also enjoyed a strong start to the year, reaching 430,000 sq ft, 57% above the first half five year average for the city centre. This was driven by the 155,000 sq ft pre let of the Bothwell Exchange to Morgan Stanley, the largest office deal in the UK regional city centres in the first half of 2016.

■ Availability in the UK regions has fallen 2% from 11.3m sq ft at the end of 2015, with supply now standing at 11.1m sq ft, the lowest level on record.

■ The M25 office supply remained constant at 17.7m sq ft. Savills calculate that there are currently 2.1 years of Grade A supply. This is down from an average of three years during the peak in 2009, with anything below two years considered as an under supply.

Outlook

■ Looking ahead, we expect to see lower levels of leasing activity and rises in lease extensions in 2016 and 2017 as businesses watch the Brexit process.

■ We expect regional take-up for the end year to reach 10.5m sq ft, 3% down on the level recorded in 2015, but 15% up on the long term average.

■ As we stand today, we can see a 5-10% fall in combined take-up levels in 2017 and 2018, however, in comparison, the key office markets saw a fall of 20% in 2008 and 2009.

■ Bristol and Glasgow are both expected to considerably outperform 2015 take-up levels, by 63% and 31%, respectively.

■ Although the current uncertainty will inevitably affect business decisions going forward, we believe there are certain sectors, which are likely to withstand this.

■ The legal and accountancy firms are likely to see higher levels of business due to Brexit, and thus are likely to see stable or higher than expected levels of leasing. The legal sector in particular will have a considerable increase in workload when the task of reviewing and re-writing the law and regulation books becomes pertinent.

■ Cost issues have been a major contributor to moves away from London over the past few years, with larger businesses looking to locate their middle and back office functions. We believe north-shoring will remain a theme over the medium term, as businesses seek to control costs in a more uncertain world.

■ As London will not see significant rental decline, then the price differential story remains in terms of some companies moving away from London, including well-connected areas of Greater London and the outer M25 office market areas.

■ Requirements from the Public Sector are expected to pick up pace going forward, which should impact take-up figures from 2017 onwards. We have already seen HMRC take 185,000 sq ft at Ruskin Square, Croydon in the third quarter, and some large government requirements in Birmingham, Manchester, Bristol and Leeds.

■ Another positive story is the regional development pipeline, this is still manageable and the majority of regional cities still have an undersupply.

■ 3.3m sq ft of space is due to complete in the regional markets over the next three years. Although this sounds like a significant amount of space, average Grade A take-up in the key regional cities is 1.5 million sq ft, resulting in just over two years of Grade A take-up being built.

■ On top of this, 35% of the development pipeline is currently pre-let, leaving just over a years worth of Grade A supply in the pipeline.

■ Manchester's pipeline up to 2018 for example, is 51% pre-let and Leeds is 40%, which demonstrates strong demand as well as a tightening pipeline.

■ With tight supply being a key theme in the UK regions over the

"We are at the stage in the cycle where total returns, are likely to be fuelled by income return, rather than capital growth."

last 12 months, refurbishment opportunities have become attractive given their speed to market and ability to 'plug the gap' while the market waits for developments to complete.

■ With 1.7 m sq ft of refurbishments set to complete by the end of 2018, landlords are capitalising on this as occupiers are looking to cut costs.

■ Examples include 191 West George Street, Glasgow and 11 Portland Street, Manchester, which are expected to provide 75,000 sq ft and 100,000 sq ft, respectively when they complete in the first half of 2017.

■ However, we expect to see a reduction in the volume of space in the development and refurbishment pipeline from 2018 as speculative development starts are put on hold or delayed.

■ Going forward, the regional markets will be more 'cushioned' compared to the London markets as they are less reliant on inward investment and more reliant on local economic dynamics.

■ One major unknown is the amount of 'grey' space coming on stream, which could see an increase in supply if occupiers begin to sub-let excess space.

■ We do expect to see gentle rises in the vacancy rates throughout the whole of the next five years, though we expect these rises to remain low enough that they do not stimulate wide spread falls in the rents being achieved.

■ We expect to see rental growth in all but one of the key regional cities in 2016, with the biggest year-on-year rental growth in Cardiff and Birmingham in 2016 with 9% & 8%, respectively at the end of 2016. This is due to certain office product and new developments commanding higher rents.

■ Although rental growth will have started to slow as we go through 2017, Bristol, Cardiff and Manchester are still predicted to see rental growth of 8%, 4% and 3% respectively.

■ With market uncertainty in the UK, potential occupiers are likely to go for a good refurbishment as a cost saving exercise. We expect to see some rental growth within the refurbishment market, however, this will be balanced against appealing to the 'cost conscious' occupier.

■ A key refurbishment letting was to Frazer Nash, who took 27,000 sq ft in the first Half of the year, at Narrow Quay House, Bristol, achieving a headline rent of £27 per sq ft. This has closed the gap between Grade A new build (£28.50 per sq ft) and refurbished space to only £1.50 per sq ft. However, we expect this gap to start to widen again going forward.

■ With a strong occupational market and the possibility of increased north-shoring to fuel demand and with the key regional cities increasingly offering the right blend of working environment, infrastructure and amenity, the UK regional office markets still have a lot to offer occupiers and investors alike.

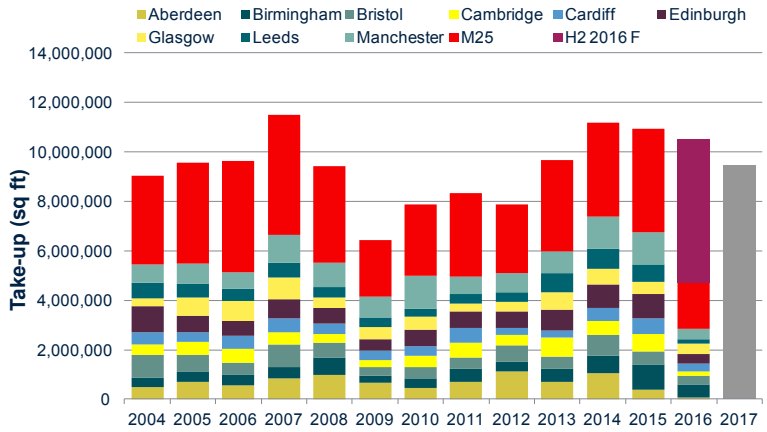
■ Investors are expected to remain cautious in the second half of 2016, as they fully consider the impact of the Brexit vote. This could involve delaying some investment decisions, although initial research suggests that investment deals are holding up well and continue to proceed.

■ Currency will play a key role for the overseas investors – rising yield with weaker sterling will stimulate interest. This is dependent, of course, on how much of a discount buyers expect to receive from the asking price.

■ We expect the end of the year to be quieter and expect to see lower investment volumes in 2016 and 2017. However, an increase in transactional levels during the final quarter of the year is anticipated, with more stock coming onto the market and more clarity of the impact of the

GRAPH 2

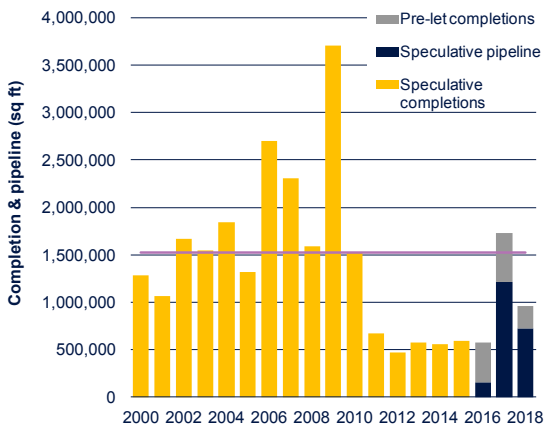
Take-up is expected to be 15% up on the long-term average by year end



Graph source: Savills Research

GRAPH 3

Spec developments are 35% pre-let



Graph source: Savills Research

Aurora, Finzels Reach, Bristol. 95,000 sq ft of Grade A, new build, due for completion in Q4 2017.

EU referendum on pricing.

■ This will drive small rises is prime yields for long-term secure income streams, and larger rises of 50bps or more for short-dated, secondary and value-add assets.

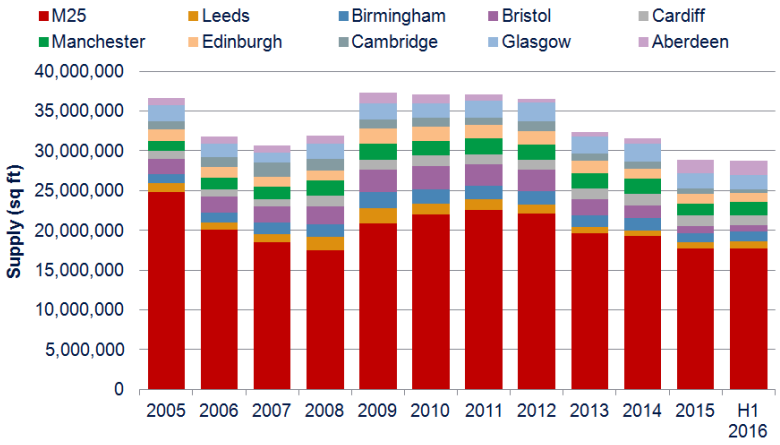
■ By the end of 2017/early 2018 these price falls, combined with the comparatively attractive return that UK offers, will stimulate a rise in opportunistic investment. This will stabilise both pricing and volumes, albeit at lower level than seen in past couple of years.

■ The reason why we see this pricing correction likely, to be much smaller than in previous cycles, is that it will be a function of the relationship between buyer and seller, rather than a collapse in the occupational markets, which has been the driver of the larger cyclical movements in yields that we have experienced in the past.

■ Caution and reduced transaction levels in the months ahead are almost certain, but in fact there remains a number of opportunities for the right buyer.

GRAPH 4

Supply is at its lowest level on record



Graph source: Savills Research

The investment market - 'Post Brexit'

■ With economic growth reaching 0.6% in the second quarter of 2016, the UK economy has performed above expectations.

■ Regional office investment to end July 2016 reached £3.7bn, up 37% on the 10 year average for this stage.

■ We expect regional investment volumes to weather the storm more comfortably than the London investment market.

■ The initial shock has taken place and now investors have looked more closely towards core assets with good covenants on long leases.

■ With overseas investors increasingly becoming important contributors to the regional property market, we can see overseas investors looking to take advantage of weaker sterling in the second half of 2016, with a relative fall in prices well received. We expect 2016 office investment volumes to end the year below 2015, but still remain above the long term average.

■ Few deals have fallen through since Brexit, with some renegotiations, but positive investment sentiment is still present.

■ In contrast to 2009, there are many purchasers and a shortage of sellers. Some opportunistic investors have been left disappointed by the discounts being offered, with yields remaining around the 5% mark.

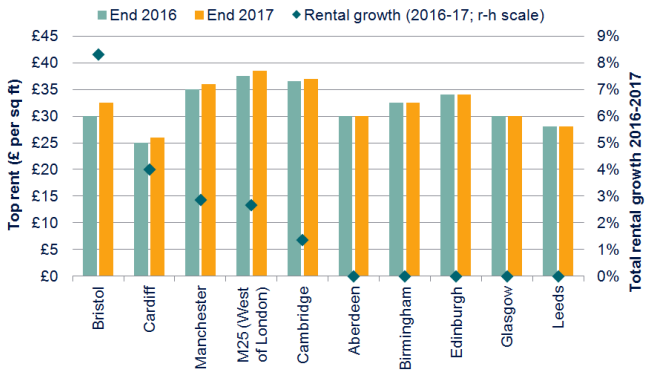
■ With the rental gap between refurbishments and new build developments at its most narrow on record, investors are looking to refurbish lower quality stock into better quality offices to attract higher rents.

■ We are at the stage in the cycle where total returns going forward are likely to be fuelled by income return and rising rental growth, rather than capital growth. RealFor predict that UK office total returns will reach 7.9% during 2016, driven by a 3.9% capital growth, whereas in 2017, we expect UK returns to fall to 4.0%, of which 3.9% is set to be income driven.

Key Charts

GRAPH 5

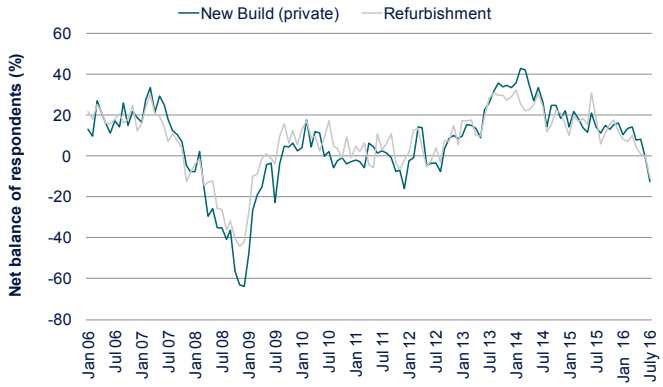
Positive rental growth is still expected



Graph source: Savills Research

GRAPH 6

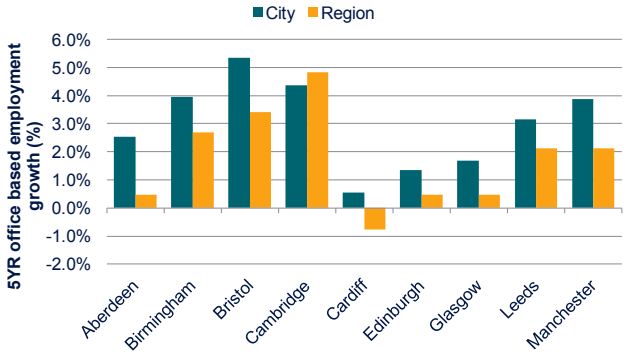
Development activity has started to slow



Graph source: Savills Research/Markit

GRAPH 7

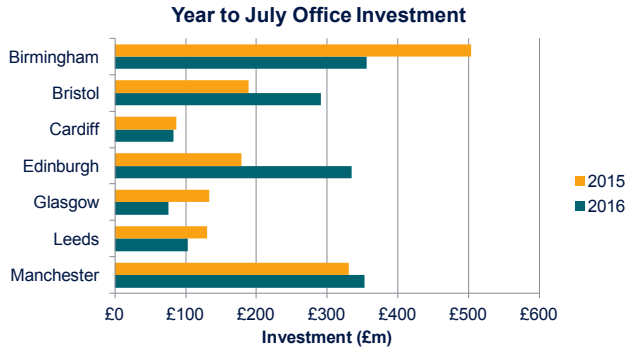
Strong office employment growth in key cities over the next five years



Graph source: Savills Research, Oxford Economics

GRAPH 8

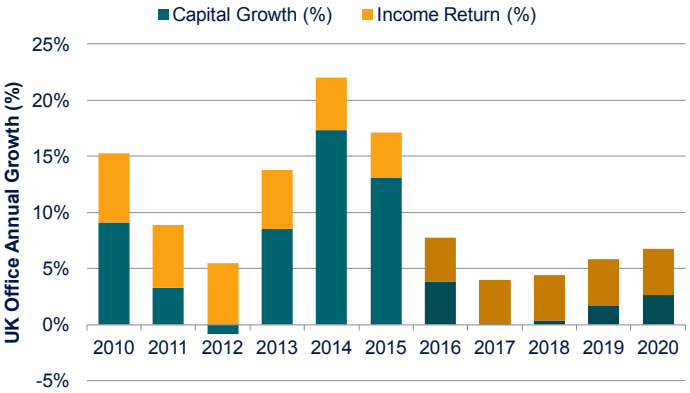
Investment volumes remain strong in the wake of Brexit



Graph source: Savills Research, Property Data

GRAPH 9

Total returns, going forward, are likely to be fuelled by income return and rising rental growth



Graph source: Realfor

TABLE 1

Definitions

Definitions	
Property criteria	Transactions and supply recorded for units in excess of 1,000 sq ft.
Top rent	Highest rent achieved in one or more transactions in the given period.
Grade A	All new development (including speculative schemes reaching practical completion within six months, plus major refurbishments).
Grade B	Space previously occupied, completed or refurbished in the last 10 years.
Grade C	Space previously occupied, completed or refurbishment more than 10 years ago.

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